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Consumer Protection**

On The Law and Economics of Interchange Fees

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Good morning, Mr. Chairman. My name is Hank Armour, and I am President and Chief Executive Officer of the National Association of Convenience Stores (NACS). Prior to taking my current job, I owned and operated fifty-nine retail facilities in Washington State, California and Oregon.

NACS is an international trade association representing the convenience store industry. The industry as a whole includes about 140,000 stores in the United States and employs about 1.5 million workers across the nation. It is truly an industry of small businesses; 60 percent of convenience stores are owned by one-store operators.

I would like to start by thanking you, Mr. Chairman, and the Members of this Subcommittee for holding a hearing on this topic. Credit card interchange fees dramatically impact consumers and are a top priority for the convenience store industry – and for merchants across many industries. These fees have actually been of concern for a number of years and have now escalated to the point that they are the third highest operating cost to my industry – behind only payroll and rent. In September, we testified before the full Committee regarding gasoline prices and the increasing amount of money that credit card companies are taking out of every gasoline purchase. Chairman Barton in particular expressed surprise at the magnitude of the fees being charged. The Committee followed up by asking for a study of this issue. While the credit card companies opposed that study, we think these efforts and this hearing are important steps toward informing the Congress and the public about these interchange fees. There has not been nearly enough information and discussion about these fees in the past and we applaud you for your willingness to examine them.



One of the reasons these fees are such a concern for my industry is that they are bad for our customers. Most consumers have no idea that they pay these fees which are hidden in the price of virtually everything they buy. Consumers search for low prices and hidden fees simply drive up the cost they must pay. This is particularly true in our industry. Gasoline prices are posted on the street and you would be amazed at what people will do – making U turns on busy streets and driving far out of their way – just to save a couple of cents on a gallon of gas. Well, right now credit card companies charge about 5 cents in interchange on a gallon of gas. I know from experience that that is a big number to our customers. Our concerns here are similar to our concerns about excise and sales taxes – but at least those taxes are publicly debated and our customers can vote based on their views about their relative costs and benefits. Credit card companies work hard to keep their fees hidden and even if our customers knew about them, they can't vote on them.

Because interchange fees have become such a large and unfair cost to our industry and our customers, we helped establish a broad coalition – the Merchant's Payments Coalition (or MPC) – to try to deal with this problem. The MPC includes 22 trade associations representing many of the retailers in your districts – grocery stores, drug stores, restaurants, bowling alleys and more. This is a very diverse group with members that do not always agree, but we have been drawn together because the costs of interchange fees affect all of us and our customers dramatically.

Interchange fees are levied in a market that is absolutely broken. The problems are so severe and numerous that NACS and a number of other trade associations and retailers are parties to more



than 50 lawsuits that have been filed against the card associations and member banks for their violations of the antitrust laws in setting these fees. In fact, the United States Department of Defense has recently filed a claim for \$100 million in a lawsuit that settled a couple of years ago based on related antitrust violations by the credit card companies for damages incurred when accepting credit card payments.

We only turned to litigation as a last resort, and contrary to what you might hear from the credit card companies or their surrogates, a great many concerned retailers and members of the MPC have not decided to take this issue to the courts. With that said, let me assure you that my purpose today is not to debate the merits of that litigation. Instead, I simply want to give the Committee some sense of the problems we face and the ways in which this market is broken.

With that in mind, there are four points illustrating the problems with the interchange fees market that I would like to cover in my remarks today. First, because of the market power of the card associations, retailers have no choice about whether they accept cards. Second, the card associations exploit their market power by driving up fees and by veiling these fees and their rules in secrecy. Third, these fees are bad for consumers – particularly some middle and many lower income consumers who do not have easy access to credit and debit cards. And fourth, consumers in the United States pay much more for interchange than other comparable countries.

1. Retailers Have No Choice

Credit and debit card transactions are a large and growing part of retailers' business. In the convenience store industry, around 60 percent of motor fuel sales are paid for with credit or debit



cards. Across all industries in the United States, in fact, the number of electronic payments – most of which are credit and debit card payments – now exceeds the number of payments by check. Plastic transactions have simply become the most predominant method of payment. My members have to take credit and debit cards.

And most of the cards in the United States are from Visa and MasterCard. As recently as 2003, the Second Circuit Court of Appeals held in the U.S. Department of Justice's case against Visa and Mastercard that the two card associations – both jointly and separately – had market power. This is consistent with other cases and with retailers' experience.

The average U.S. consumer carries a limited amount of cash at any given time. Consumers also have an average of 9 credit cards. So, what happens? When consumers want to buy something that costs more than about \$20 – like filling up their tanks with gasoline which cost about \$23 last year – that transaction is likely to go on a credit or debit card. This has played out in the gasoline retailing business. As gasoline prices increased and the cost of the average fill-up went above \$20 or so, card usage rose dramatically.

Maybe this is because U.S. consumers receive well over 5 billion mail solicitations for credit cards each year. That is more than 20 solicitations for every man, woman and child of all ages every year – and that doesn't even count the phone calls. Many of us have anecdotal stories of minor children, deceased individuals and even family pets receiving those mailings – sometimes with promises of large preapproved credit lines. But whatever the reason for the boom in cards



and card usage, it is clear that cards – particularly from Visa and MasterCard – are so ubiquitous that most retailers simply have to take them.

2. Card Associations Drive Up Fees and Keep them and their Rules Secret

The card associations set interchange rates for all of their member banks – and all of those member banks must agree to charge the same rates. Of course, the boards of the card associations that make those decisions are made up of member banks so this is nothing more than price-fixing. The fact that they get away with it amazes me, but the courts will decide whether their questionable legal basis for this practice is still valid.

Just to give you a sense of the magnitude of the fees we are talking about, we and our customers pay more than \$27 billion in interchange fees each year in this country. When all of the other fees on credit and debit transactions are included, the tab increases to over \$39 billion. And this figure does not include the many other fees collected directly from consumers such as annual fees, late fees, interest and the like.

We calculate that an average convenience store paid about \$31,000 in interchange fees in 2004. That same store only made \$36,000 in **pre-tax** profits in 2004. The fact that our members on average are paying almost as much to the credit card companies each year as they are making before they pay Uncle Sam gives you a sense of just how broken this market is.

Even more problematic is the lengths to which the credit card companies go to assure that consumers remain in the dark about these fees. This system is so complex it makes your phone



bill seem easy to understand. But at least somebody tries to tell you about all of the fees that are tacked onto your phone bill every month. You don't even get that privilege with your credit card purchases.

Retailers are told by their banks that the rules prohibit them from telling consumers about the interchange fees charged for different transactions and about the operating rules. This conspiracy enforced by the credit card companies to keep information from consumers is a key element of the problems in this market. How can consumers possibly decide what is in their interest if the credit card companies keep this information secret?

Another major part of the problem is that Visa and MasterCard compete by raising – not lowering – their interchange rates. When they raise their rates they compete to get their bank members to issue more of their cards. Higher interchange rates mean those banks, in turn, get more money from transactions put on those cards. There is not a sufficient check against those rising rates because the market power of the credit card companies inhibits retailers from refusing to take a card with higher interchange rates and because consumers – who ultimately pay the fees – do not have good information about the charges.

Retailers are not given a comprehensible disclosure of the rates they are charged. The card associations have a complex matrix of interchange rates. These rates range from about 5 cents plus 1.15% for each transaction to 10 cents plus 2.7% of the transaction. But it is hard for retailers, particularly small mom-and-pop stores, to figure out why they fall into a particular rate category based on their supposed fraud risk and the like. Plus, a retailer may be charged



different rates within the course of the same business day. If, for example, a card swipe doesn't work and the retailer needs to call to get authorization, the transaction then falls into a different risk category and a different interchange rate is charged. And if the phone call doesn't go through (such as in the post-hurricane situation) then a higher rate is charged.

It's not just consumers who are left in the dark; Visa and MasterCard refuse to fully disclose their operating rules to retailers. MasterCard has at least put a summary of its rules on its Website. But a summary is not the same thing as the complete set of rules – and the summary alone is more than 300 pages. It is remarkable that they make retailers agree to abide by all of their operating rules in order to be able to accept their cards, yet they won't let retailers see those rules. I find the lack of transparency by Visa and MasterCard to be outrageous.

One classic example of the way that Visa and MasterCard compete to drive up interchange occurred in 1998 through 1999. In May 1998, Visa announced that it would increase its offline debit interchange fee by about 20 percent. The increase was to take effect in April 1999. In November 1998, however, MasterCard announced a 9 percent increase (also to take effect in April 1999) that was enough to keep its fee higher than Visa's. In most competitive markets it would have been a chance for MasterCard to hold or lower prices to gain market share – but the reality is just the opposite when both card brands enjoy merchant acceptance of over 98 percent. In fact, those increases were just the start. In January 1999, Visa announced it would increase its fee by an additional 6 percent. Then MasterCard announced another increase five days later. All of these increases were made before the first rate increase even took effect. When the dust



finally settled, Visa's rates went up 26 percent and MasterCard's went up 17 percent. Overall, these increases alone cost U.S. consumers an additional \$300 million per year.

3. These Fees Are Bad for Consumers

Not only is this a big concern for us as retailers, but the current situation is tremendously unfair to consumers. Ultimately, consumers pay for all of this. The average American family pays \$331 in interchange and related fees every year. And that is true whether or not that family uses a single credit or debit card. Because these fees are hidden in the cost of virtually everything we buy, even cash-paying consumers ultimately pay for them.

There are many particularly glaring examples of situations in which people have no choice but to accept credit and debit card payments even though the fees that are charged do not make sense or are directly contrary to the public policy that most people would support.

One example which has been of great concern to the retail community is what happens in the wake of hurricanes and other disasters. Retailers often go to great lengths to open their doors following disasters so that people in the affected area can get the basic goods that they need to survive. That was never more evident than in 2005. Not only the Gulf but parts of the State of Florida were hit with devastating hurricanes last year. In these areas, many retailers had to operate without (or with sporadic) electricity and phone service. The cruel and sobering reality for these retailers and their customers was that the credit card companies charged them among the highest interchange rates for their efforts because without electricity or phone service retailers could not swipe cards or call to get preauthorization before completing a transaction.



Instead, they sometimes used the old fashioned method of running the card and a receipt with a carbon copy through a machine and getting a signature. But without a preauthorization the retailers – and, ultimately, the consumers who were hit so hard by the hurricanes – had to pay the exorbitant, higher rates because of the supposed risk of fraud – almost 60% more than the standard rate of 1.89% of the sale.

This results in a nasty, regressive charge. In short, people who get the fewest benefits from credit cards subsidize those who get the most benefits. This hidden regressive tax levied by an unregulated private monopoly should not be ignored. Consumers with fewer resources whose credit does not allow them to have credit cards or do not have debit cards pay this fee like everyone else – as do consumers with credit cards who pay high interest rates, annual fees and have no rewards or miles programs. And this is the *vast* majority of consumers.

One of the reasons this problem is so pernicious is that it is hidden. ATM fees are a good point of comparison. How much do we pay each year in ATM fees? About \$4 billion. Interchange fees are almost 7 times as much – and when other, related fees are included the difference is far more than that. Why isn't there more of an outcry about interchange fees? Because while consumers see every ATM fee they pay and have some ability to choose an ATM that carries a smaller surcharge, the credit card companies go to great lengths to try to ensure that interchange fees remain hidden.

The credit card companies are often quick to point to rewards programs and airline miles as benefits to consumers. But those rewards don't look very good when you understand that



consumers pay for each dollar of rewards with several dollars in interchange fees. It is also important to keep in mind that most credit cards do not come with rewards programs. Convenience store customers, in fact, only use a card that earns rewards for about 1 out of 7 transactions. And what about the annual fees, interest payments, late fees and multiple other charges that credit card holders must pay directly? Just more monopoly profits for the credit card companies who get consumers coming and going – and then they have the gall to tell their customers how great it is they get a few airline miles or rewards points for all of the extra money they have been charged. As you watch the credit card ads during the Olympics this week, make sure to enjoy them. You are paying dearly for them.

4. The United States Pays Far More than its Share of Interchange Fees

U.S. consumers are, in effect, subsidizing credit card company operations around the world. Interchange rates are far higher here than they are in comparable countries. They are also higher here than in several countries that we wouldn't even think of as remotely comparable in this area. You can take a look at the chart showing interchange in different countries to get a sense of just how bad this comparison is for us. And bear in mind that this chart was prepared before last year's dramatic effective increase in fees. We have the highest volume of transactions, which should lead to significant economies of scale and lower interchange rates. We also have the best technology for processing these transactions and we have very low, and decreasing, rates of fraud. Yet U.S. rates are higher than in other countries and they are rising – while the rates in most other countries are flat or declining. Our interchange rates ought to be the lowest in the world.



It is one thing for us to pay about double the rate paid in places like Great Britain, the European Union and Australia. The credit card companies will spend a lot of time complaining about the regulatory systems in those places. Of course, they typically don't mention that the rates were far higher here than in any of those places even before their regulators took action. But how can anyone think it makes sense for us to pay higher interchange rates than people in Malaysia, Greece and Brazil? Does the United States really have a riskier and costlier credit system than those countries?

The answer is that we don't, but because of their market power the credit card companies can get away with charging more here – so they do. It is that simple.

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All of this is just a small part of the explanation of how the market for interchange fees in the United States is broken. Something must be done to fix it. I look forward to working with the Members of this Committee and the entire Congress to find the right solutions to this problem and I welcome your questions.

International Interchange/Discount Rates

(Visa & MasterCard)

